

This letter applies the exemption for computers used primarily in operating exempt equipment in a CAD/CAM system. See Section 130.330. (This is a PLR.)

March 3, 2000

Dear Xxxxx:

This Private Letter Ruling, issued pursuant to 2 Ill. Adm. Code 1200 (see enclosed), is in response to your letter received on February 16, 2000. Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of the enclosed copy of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to COMPANY for the issue or issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither COMPANY or a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

In your letter you have stated and made inquiry as follows:

"As instructed by DCCA's PERSON1 and PERSON2, and in conjunction with our November 30, 1999 letter to Governor George Ryan concerning COMPANY's (the 'Company') location/relocation decision:

"We respectfully request a Private Letter Ruling from the Illinois Department of Revenue that COMPANY is not liable for Illinois Use Tax ('UT') or Retailers' Occupation Tax ('ROT') on machinery and equipment it purchases and uses under the circumstances described below. This matter relates to current, future, and 1999 periods, and there is no Illinois Department of Revenue Audit or investigation of this matter pending. To the best of our knowledge, the Department has not ruled on the same or similar issue on behalf of the company or any predecessor, nor "have we submitted the same or a similar issue to the Department but withdrew it before a letter ruling was issued.

**"FACTS:**

"COMPANY is an Illinois corporation with its place of business in the CITY, and is the nation's leader in the manufacture of embroidered/silkscreened personalized apparel/clothing for sale (Products include uniforms, shirts, hats, for example).

**"MANUFACTURING PROCESS:**

**"The manufacturing process at COMPANY incorporates state-of-the-art computers and software into the manufacturing machinery and equipment (such as embroidery and automated screen print machines) with a fully integrated computer assisted design and computer-assisted manufacturing system ('the COMPANY CAD/CAM system'). The activities, workflow and equipment are linked together into a single-integrated process. The COMPANY CAD/CAM System provide control over the elements of the manufacturing activities and manufacturing equipment.**

"The manufacturing process is initiated with an order and entered into the COMPANY CAD/CAM system. The COMPANY CAD/CAM system platform is Oracle 8i, which is also supported with a digital asset management system that facilitates the graphic portion of the order (the artwork, logos, monograms, etc.). Though screen 'pages', the functional design requirements are filled in through a series of mouse 'clicks' which triggers the manufacturing requirements, including the 'blank' item (such as a t-shirt or a polo), size, quantity, and graphic to be decorated on the blank. NAME software translates/converts the electronic requirements into other software platforms that advance the manufacturing process throughout the plant facility.

"The translated customer requirements move through the manufacturing process via two fully integrated systems: an IBM AS/400 host system and the graphics management system. Both systems have several subsystems of supporting hardware and software technologies, but all of which are fully integrated into the COMPANY CAD/CAM System.

"The AS/400 software environment of the COMPANY CAD/CAM System facilitates decoration management as to specific production "processes. The graphics management software system facilitates the receipt of the graphic file from the customer and deployment of the graphic to the appropriate decoration process. From the web digital asset management system, the graphic image is deployed through an image server. A quality control review is performed on the electronic graphic by the art departments and the electronic graphic image is approved. The next step depends on the decoration process selected by the customer (either embroidery, screen print, or heat transfer).

"For embroidery orders, the approved electronic graphic resides in the electronic embroidery network as a 'digitized logo'. Once the job is scheduled for production, the digitized graphic is electronically pulled from its computer file into the state-of-the-art computerized embroidery machines. The embroidery machines stitch the electronically stored digitized graphic on the garment. For screen print orders, the approved electronic graphic is electronically sent for electronic color separation. For heat transfer orders, the approved graphic is also electronically sent to a color printer equipped with special paper which generates the actual 'iron-on' decal. The decal is then affixed to the blank garment.

**"Thus, in all cases the computers and software platforms at COMPANY are fully integrated into the manufacturing machinery and equipment. This integrated COMPANY CAD/CAM System provides control over all of COMPANY's manufacturing activities and manufacturing equipment.**

#### **"ISSUE:**

**"Whether COMPANY's manufacturing equipment, including computers and integrated software used primarily in operating exempt machinery and equipment in a computer-assisted design, computer-assisted manufacturing (CAD/CAM) system, qualifies as exempt manufacturing equipment under the Manufacturing Machinery and Equipment exemption contained in 86 Ill. Adm. Code 130.330 (the 'Statute').**

#### **"DISCUSSION:**

"The Statute exempts from tax sales of machinery and equipment used primarily in the manufacturing or assembling of tangible personal property for wholesale or retail sale or lease. It is acknowledged, and the "Company's manufacturing process fully complies with the Statute's definition which requires that the:

The manufacturing process is the production of any article of tangible personal property, whether such article is a finished product or an article for use in the process of manufacturing or assembling a different article of tangible personal property, by procedures commonly regarded as manufacturing, processing, fabricating or refining which changes some existing material or materials into a material with a different form use or name. These changes must result from the process in question and be substantial and significant. (86 Ill. Adm. Code 130.330(b)(2))

"As contained in Section c(3) of the Statute:

Equipment includes an independent device or tool separate from any machinery but essential to an integrated manufacturing or assembling process; **including computers used primarily in operating exempt machinery and equipment in a computer-assisted design, computerassisted manufacturing (CAD/CAM) system**; any subunit or assembly comprising a component of any machinery, such as tools, dies, jigs, fixtures, patterns and molds; and any parts which require periodic replacement in the course of normal operation. ... (emphasis added)

#### **"PRIOR AUTHORITY:**

"A 1991 Ruling is directly on point to the circumstance and certain of the equipment used in the instant matter (the '1991 Ruling')(emphasis added):

*ST 91-0625 – 08/08/1991 MANUFACTURING MACHINERY AND EQUIPMENT The application of the Manufacturing Machinery and Equipment Exemption to CAD/CAM systems is set out at 130.330(c)(3)*

*This will acknowledge receipt of your letter dated May 8, 1991 in which you have requested a ruling concerning:*

*'...whether or not a manufacturer of resale goods is exempt from paying sales tax on the purchase of a computer system for producing custom embroidery designs. This equipment produces a computer program that directs a computer driven machine (similar to a giant sewing machine) to sew, for example, a Los Angeles Raiders logo on to a jacket, shirt, baseball cap or any other type of apparel. As a result of the embroidery, the garment is more valuable to the consumer than a garment without the embroidery.'*

*For informational purposes, we are enclosing a copy of ....*

***We understand the situation you have described to involve the manufacturer of the garment using the computer to operate an on-line embroidery machine to***

***embroider logos on garments being manufactured for wholesale or retail sale. In such a situation, the exemption would be available. The exemption would not be available for the computer (or for the embroidery machine) if it were used by someone engaged in the business of embroidering logos on garments owned by individuals.***

*Very truly yours,  
George Sorensen  
Assistant Manager*

"The Company also references prior Letter rulings numbered:

"ST 96-0546 – 12/27/1996 (the 1996 Letter') in which a taxpayer whose 'significant portion of their business consists of custom order silkscreened and/or embroidered products....' The Letter states, in relevant part, 'in general, equipment in a computer-assisted manufacturing system that includes a computer that operates an on-line embroidery machine to embroider computerized designs "on garments being manufactured for subsequent wholesale or retail sale would qualify for the manufacturing machinery and equipment exemption. However, 'manufacturing' does not include the activities of retailers who perform embroidering or monogramming services as the final stage of preparation of times prior to their retail sale.

"ST 97-0345-GIL 06/17/1997 (the '1997 Letter') in which a taxpayer 'purchased a computer, Scanner, & a Canon B-Jet Printer to make our own T-Shirt transfers.' The letter states that 'manufacturing' does not include the activities of retailers located at retail outlets who personalize tangible personal property as the final stage of preparation of that item prior to its retail sale. Such persons would include retail stores that perform monogramming or t-shirt stands that transfer artwork chosen by the customer onto t-shirts or other wearing apparel. However, if persons engage in silkscreening production operations in which they transfer images by silkscreening onto wearing apparel that is subsequently offered for sale, they would be considered manufacturers.'

**"In the instant matter, and referencing the 1996 and 1997 Letters: No embroidering or monogramming services are performed as the final stage of preparation of items prior to their retail sale. Thus the exemption applies.**

"Like in the 1991 Ruling set forth above:

**"COMPANY's manufacturing process involves the manufacturer of garments using the computer to operate an on-line embroidery machine to embroider logos and other equipment to personalize garments being manufactured for wholesale or retail sale. Moreover, the computers and integrated software are utilized in operating the machinery and equipment in a computer-assisted design, computer-assisted manufacturing (CAD/CAM) system, with each of the activities and items of the manufacturing equipment tied together in a single, integrated process ('the CAD/CAM System').**

**"The CAD/CAM System provides control over all of COMPANY's manufacturing activities and items of manufacturing equipment. No work is performed on**

garments owned by individuals. Therefore, COMPANY's manufacturing equipment, including computers and integrated software used primarily in operating exempt machinery and equipment in a computer-assisted design, computer-assisted manufacturing (CAD/CAM) system, qualifies as exempt manufacturing equipment under the Manufacturing Machinery and Equipment exemption contained in 86 Ill. Adm. Code 130.330.

**"REQUEST FOR RULING:**

"We would appreciate it if you would issue a ruling confirming that COMPANY of Illinois is not liable for the UT or ROT on the machinery and computers described above. Please include DCCA's PERSON1 and PERSON2 in such a communication as they are actively engaged in retaining COMPANY as a corporate citizen of Illinois. Thank you for your time and cooperation in this matter."

Machinery and equipment used primarily (over 50% of the time) in the manufacturing or assembling of tangible personal property for wholesale or retail sale or lease are exempt from Retailers' Occupation Tax. See the enclosed copy of 86 Ill. Adm. Code 130.330. The manufacturing process is the production of any article of tangible personal property, whether such article is a finished product or an article for use in the process of manufacturing or assembling a different article of tangible personal property, by procedures commonly regarded as manufacturing, processing, fabricating, or refining that changes some existing material or materials into a material with a different form, use, or name. These changes must result from the process in question and be substantial and significant.

We understand from the information that you have submitted that COMPANY is a manufacturer of embroidered and silkscreened apparel (for example, shirts, hats, uniforms) that is subsequently sold to customers at retail. The manufacturing machinery and equipment exemption would extend to qualifying types of machinery or equipment used by a manufacturer that embroiders or silkscreens apparel, such as tshirts, uniforms or hats.

Section 130.330 (c)(3) describes the application of the manufacturing machinery and equipment exemption to computer-assisted manufacturing systems. The exemption applies to equipment, "including computers used primarily in operating exempt machinery and equipment in a computer-assisted design, computer-assisted manufacturing (CAD/CAM) system." As the regulation indicates, computers used in a CAD/CAM system must be used primarily (i.e., over 50%) in the manufacturing process. If the computers are used primarily, for instance, to create the image which will be embroidered on t-shirts, or for accounting or inventory purposes, they will not qualify for the exemption. This is true, even if use of the computers is essential to the manufacturing process as a whole. While computers may perform functions which are critical to the manufacturing operation, only computers used primarily to *operate exempt machinery or equipment* in a CAD/CAM system will qualify for the exemption. Thus, computers used primarily in job scheduling, inventory control, accounts receivable, payroll or other accounting or managerial functions do not qualify for the exemption, even if they are considered essential to the manufacturing operation.

On February 29, 2000, EMPLOYEE, of COMPANY, PERSON2, from the Department of Commerce and Community Affairs, and ATTORNEY, COMPANY's attorney in this matter, and I had a teleconference in which the computers used at COMPANY were discussed in greater detail. As a result, we understand that 14 computers are used by COMPANY in the process of customizing apparel. These computers are not used for any other purpose, such as accounting or billing.

Eight of the computers are used exclusively to digitize the image which will be imprinted upon the garment. Digitization is a process, as we understand it, of converting an existing graphic image into a format, or instructions, which the embroidery machine can "read," and by so reading, can stitch (or screen print or heat transfer) a specific image onto the garment. You have indicated that these computers, in essence, "operate" the stitching equipment by triggering and guiding specific embroidery sequences, including the utilization of specific thread and colors, as well as placement of the logo on a specific portion of the garment. In a more antiquated manufacturing process, a human being would have stood at the embroidery machine and manipulated it to perform these types of movements. However, the computer now assumes these functions and executes the stitching of the garment. You have represented that these eight computers are used exclusively for these functions. Accordingly, we believe they will qualify under the manufacturing machinery and equipment exemption. Specifically, these eight digitizing computers qualify because they are used primarily to "operate" exempt machinery and equipment -- the embroidery, screenprinting or heat-transfer machines -- in a CAD/CAM system.

Our conversation included discussion of the remaining 6 computers used in the manufacturing process. These computers, as we understand it, are terminals used with the AS/400 software system. The AS/400 system is used to manage the production floor. This system, in a nutshell, monitors the manufacturing process from placement of an order until the order is shipped out of the system. For example, these computers are used with the AS/400 software to ensure that once an order is received, the materials necessary to fulfill that order are procured from suppliers. When a customer order is received, the computer is used to input the specific requirements of the order, including the number of t-shirts ordered and the correct sizes, along with the graphic to be applied and the timeframe requested by the customer. It is then used to place an order for those specific t-shirts with a supplier. The computer monitors the progress of the supplier order with attention to specific production timeframes. When the t-shirts arrive at the plant, the computer flags the t-shirts as received, and schedules them to be customized by a particular process (e.g., embroidery). The computers are used to monitor when the image has been properly digitized, and when the artwork has received final approval. They monitor arrival at, and completion of, each stage of the customization process. In this manner, production of the item is kept moving, and does not falter. You assert that these computers also trigger embroidery of the garment, since the AS/400 software must acknowledge that the order has arrived at the stage at which the machines must be instructed to stitch the image, before the eight digitizing computers will in fact direct the machine to stitch the garment. Your position is that the six computers used with the AS/400 are thus fully integrated into the manufacturing process and are essential to it.

Based upon the information you have provided, both in our teleconference and in your letter, we do not believe that the 6 computers used in conjunction with the AS/400 system qualify for the manufacturing machinery and equipment exemption. In our conversations, you could not unequivocally state that these computers were used over 50% of the time to operate the embroidery equipment. In fact, from all the information submitted, they appear to be used primarily to input specific customer requirements when orders are received, and to procure supplies from vendors to fill those orders. Employees use the computers to monitor the production process throughout all stages until completion. By monitoring the process, an employee can keep the production process moving to the next stage. This monitoring function ensures that deadlines can be most efficiently met. While these computers may be essential to the manufacturing process, especially in a high-tech integrated manufacturing process such as yours, they cannot be said to be used primarily to "operate" exempt machinery and equipment. As you can see from the specific provisions of subsection (d)(2) of Section 130.330, for purposes of the exemption, "[t]he fact that particular machinery or equipment may be considered essential to the conduct of the business of manufacturing or assembling because its use is required by law or practical necessity does not, of itself, mean that machinery or equipment is used primarily in manufacturing or assembling."

We have based these rulings upon our understanding of your integrated manufacturing process, as explained to us in both the teleconference and your letter. If our understanding is incomplete or incorrect, we welcome additional information.

A large portion of our teleconference centered on the importance of the software used by COMPANY in its manufacturing process. The manufacturing machinery and equipment exemption only includes computers used primarily in operating exempt machinery and equipment in a CAD/CAM system. The exemption does not apply to software used in qualifying computers in a CAD/CAM system. Software is neither machinery nor equipment, and, for that reason, it cannot qualify for the manufacturing machinery and equipment exemption. Your letter did not contain the type of information about the purchase of the software, such as the existence of specific licensing agreements, which we would need to review in order to make a ruling regarding its taxability. We have, however, included a copy of our regulation governing the taxation of software (see the enclosed copy of 86 Ill. Adm. Code 130.1935). As you can see from this regulation, canned computer software is subject to tax. However, a license of software is not a taxable retail sale if:

- a) it is evidenced by a written agreement signed by the licensor and the customer;
- b) it restricts the customer's duplication and use of the software;
- c) it prohibits the customer from licensing, sublicensing or transferring the software to a third party (except to a related party);
- d) the vendor will provide another copy at minimal or no charge if the customer loses or damages the software; and
- e) the customer must destroy or return all copies of the software to the vendor at the end of the license period.

If transactions for the licensing of computer software meet all of the criteria provided in Section 130.1935 (a)(1), the transfer of the software will not be subject to Retailers' Occupation Tax.

As stated above, a license of computer software is not taxable if it meets all of the criteria listed in Section 130.1935 (a)(1)(A-E). However, subparagraph (D) requires the license to contain a provision requiring the vendor to provide another copy at minimal or no charge if the customer loses or damages the software. The Department has deemed a software license agreement to have met this criterion if the agreement does not contain such a provision, but the vendor's records reflect that it has a policy of providing copies of software at minimal or no cost if the customer loses or damages the software.

Subparagraph (E) also requires a license to require a customer to destroy or return all copies of the software to the vendor at the end of the license period. The Department has also deemed perpetual license agreements to qualify for this criterion even though no provision is included in the agreement that requires the return or the destruction of the software.

Please be informed that legislation is currently pending with the General Assembly (House Bill 3897) which would modify the current manufacturing CAD/CAM exemption by allowing the exemption for a CAD/CAM system contributing to a manufacturing or assembling process. The manufacturing exemption for a CAD/CAM system, in other words, would not be limited, as it is now, to computers which are used primarily in operating exempt machinery and equipment in a CAD/CAM system.

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation, or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

I hope that this information is helpful. The Department of Revenue maintains a Web site, which can be accessed at [www.revenue.state.il.us](http://www.revenue.state.il.us). If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,  
Jerilynn Gorden  
Senior Counsel, Sales & Excise Tax